



MICHAEL J. MURPHY
State Treasurer

Third Quarter 2003

The QUARTERLY

Local Government Investment Pool

The jobless economic recovery moves onward

Consumer activity showed marked improvement and resilience during the third quarter of calendar year 2003, giving investors hope that the U.S. economy is on track for a second-half recovery. The tax cuts, federal tax withholding rates and child tax credits implemented at the start of summer season bolstered retail sales across the country.

Another important catalyst was the strong real estate activity in mid-July and August. Gross Domestic Product (GDP) for Quarter 2 of 2003 grew at an annualized pace of 3.3 percent. Although the labor market was still very soft, unemployment figures have shown an improvement from the July trough. However, the slack in the labor market will continue to highlight the risk to recovery.

The Federal Open Market Committee (Fed), during its October meeting, signified that although the threat of disinflation was still real, it was less of a threat than it had appeared to be at the June meeting. The Fed also maintained its "balanced" growth outlook and its accommodative stance. The committee issued a statement that it will leave rates low even if growth reaccelerates to reduce the excess capacity plaguing the economy.

After lowering the fed funds rate from 1.25 percent to 1 percent at its June meeting, the Fed made no changes at the September and October meetings. Also, the Fed did not change its outlook language during the October meeting except for its assessment of labor market conditions from "weakening" to "stabilizing" and consumer spending as "firming." The Fed also reiterated that the "risk of undesirably low price increases is a predominant

concern for the foreseeable future," which might compel it to keep interest rates low for a considerable period.

Productivity, which is a measure of how much work an employee performs, shot up to 6.8 percent during the second quarter of 2003. This rise in productivity has enabled companies to produce more without hiring additional workers. In fact, during this period, companies were able to eliminate more jobs without affecting output. Technology has been cited as the primary driver to the enhanced efficiency.

Jobs in the manufacturing sector have been the most severely affected as most firms are having difficulty competing globally due to the relative cost advantage of producing labor-intensive products in China. Alternatively, the service industries were the biggest beneficiaries of the surge in productivity. However, even service sector jobs are at risk as large blue-chip companies have started exporting jobs to India and Southeast Asian countries. These external factors mentioned, in addition to weak capital spending, have given companies time to rethink their labor needs.

Economists have reiterated their position that labor productivity probably could not sustain quarter-on-quarter growth and that this could eventually affect labor market conditions. Companies have been wary of adding workers when they still have a lot of unused capacity. Industrial capacity dropped to a 20-year low of 74.7 percent in August and was unchanged in September. However, all is not lost in numbers, as inventories have experienced a marked drawdown and the low inventory-to-sales ratio signals restocking in Quarter 4. All

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Market summary: Fed moving toward tightening in '04?

from page 1

told, most of the labor woes are not going away soon which could be part of the Fed's decision to watch very closely the country's ability to create more jobs in the future.

There are other areas of the economy experiencing recovery. Capital spending, which heretofore had appeared stagnant, was up 7.3 percent in Quarter 2, with equipment spending up 8.3 percent. The Institute for Supply Management (ISM) index went up in August to 54.7 and eased to 53.7 in September. Although the strength of the ISM number could be debated, numbers above 50 cannot belie the fact that there is still an improvement. Dissecting the ISM index also shows that the order component has risen five times in a row, pointing to a robust fourth quarter.

The stock market continued its ascent, amidst a backdrop of better corporate earnings and a healthier corporate outlook. Most listed companies have expressed renewed optimism about consumer demand. The DJIA, S&P 500, and the NASDAQ have registered year-to-date gains of 18, 15, and 41 percent, respectively. Investors have been very bullish, believing that better corporate earnings will continue in Quarter 4. Investors were also heartened to see the latest jobless claims number (October 18) drop to 386,000 from 390,000. It was most encouraging to see that weekly claims have fallen far below the 419,000-high registered in April.

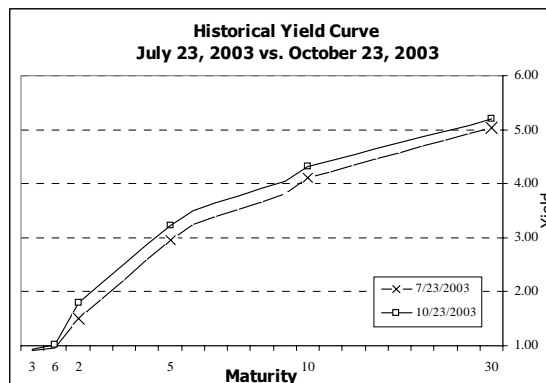
The bond market recovered from its disastrous performance in July to register decent gains in September. The idea that the Fed will remain on hold for a "considerable period" of time before raising rates has taken root and the market has rallied from its July lows. However, the gains the bond market posted in September dissipated somewhat in October as the outlook on unemployment became rosier.

Strong economic results have prompted some

investors to sell their holdings and to predict that the Fed may begin tightening as soon as 2004. Despite the September rally, rates have gone up in the last quarter. The yields on three-month and six-month bills have risen by 3 and 6 basis points (bp), respectively, while the 2-year note yields gained 30 bp and 3-year notes were 33 bp higher. The 5-year, 10-year, and the long-bond registered higher yields of 28, 21, and 15 bp, respectively.

The net return on the LGIP was 1.09 percent in July, 1.06 percent in August, and 1.07 percent in September. The targeted fed funds rate has been at 1.00 percent since late June. As long as the fed funds rate remains unchanged, the LGIP net rate will continue to inch its way to 1.00 percent.

The FOMC meets twice before the end of the year, in October and December. No changes in rates are expected at either meeting and current sentiment is for targeted fed funds to remain steady well into 2004. The LGIP portfolio, its average life currently at 57 days, continues to maintain a neutral stance. Should there be changes in the general attitude of the market, the portfolio is positioned to shift accordingly.



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Notes from the October 10 LGIP advisory meeting

The LGIP Advisory Committee met Oct. 10. A brief update was given on the net LGIP returns for January through August 2003. The LGIP net rate ranged from 1.09 percent in July to 1.07 percent in September. The fed funds rate remained at 1 percent. In the first eight months of the calendar year the LGIP has outperformed its benchmark by 42 basis points (bp). While the LGIP has outperformed iMoneyNet, Inc., the spread is a little less than it has been in past years. This is primarily due to a combination of lower rates and a reduction in fees by some of the funds due to the low rates.

The current strategy for the management of the LGIP portfolio was discussed. Currently, the portfolio has an average life of 55 days, reflecting a neutral stance. As year-end approaches, the average life will become a little shorter to allow for anticipated end of year opportunities. The current market provides few options for positive carry. No changes in the targeted fed funds rate is anticipated at the next two Fed meetings, to be held Oct. 28 and Dec. 9. Advisory committee members discussed general market conditions, their cash balances and the economic outlook of the state.

The Fiscal Year (FY) 2003 and 2004 budgets were reviewed utilizing a handout provided to committee members. The actual fees and overdrafts were slightly higher than the estimate for FY 2003 due to a higher than anticipated average balance for FY 2003 of \$4.9 billion. The actual expenses were also slightly higher than the FY 2003 estimate. The rebate for FY 2003, which was \$1,178,027, was higher than originally estimated.

The average balance for FY 2004 is estimated to be approximately \$4.0 billion. Expenses for FY 2004 are estimated to be \$45,000 higher than FY 2003 actual expenses. Most of this increase is attributable to correcting an oversight. In prior years, the LGIP has not been charged a proportional share of LAN applications and support. Going forward, the LGIP will be charged for its share of those services, estimated to be about \$32,000 per year. The estimated rebate of \$802,000 would result in an actual administration fee for FY 2004 of about 1.5 bp.

The content and courses offered at this year's Public Finance track at the WFOA conference

were a success and many positive comments were received from the attendees. The three-part Portfolio Management series was well received and many people appreciated that it was a more advanced look at investing. Advisory committee members were interested in some non-conference sessions.

The State Auditor's Office (SAO) took a limited look at the TM\$ application and provided their findings to the external auditors, Peterson Sullivan, PLLC. The results of the SAO audit were positive. A few minor issues were noted that are already being addressed by OST.

A brief report was given on the audit with Peterson Sullivan. OST staff has been very pleased with its work, expertise, and ideas. A few revisions were suggested to update the Investment Restrictions section of the LGIP Investment Policy. The committee passed a motion to recommend that Treasurer Murphy approve LGIP Investment Policy revisions. Based on a unanimous recommendation, Treasurer Murphy approved the revisions.

Investing 101

from page 5

funds rate, i.e., six weeks at 2.25 percent, six weeks at 2.5 percent and five weeks at 2.75 percent, the LGIP would average 2.49 percent over the four-month period in a best-case scenario. Now the four-month security at 2.65 percent really does appear to be the best option, exceeding the LGIP scenario by 16 bp.

Clearly, many factors come into play when evaluating the LGIP as a short-term investment. Besides estimating the LGIP's current yield, we need to have an idea where that yield is likely to be in coming months. To accurately estimate the LGIP's forward yield, it is essential to pay attention to the targeted fed funds rate and market expectations. Often we can use a best- or worst-case forward yield to help us evaluate.

It would be impossible to cover every potential scenario in this space, but we hope to have presented some points to consider when making your investment evaluations.

*If you have questions about this topic, or any of the **Investing 101** articles, call Lisa Hennessy at (360) 902-9013.*

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Investing 101: Figuring the LGIP into gap analysis

Part 1 – Estimating the forward yield of the LGIP

The following article is part of the "Investing 101" educational series, which focuses on basic investment issues. We hope you find these articles informative and helpful.

As we determined in the previous **Investing 101** installment ("Gap analysis and the implied forward rate," Second Quarter 2003), gap analysis is a mathematical evaluation of short-term funding strategies for money market instruments on a breakeven basis. Or, more simply, a means of comparing two short-term investments vs. an equivalent longer term investment.

In the previous article we compared two 3-month securities against a 6-month security. But what if we want to consider the LGIP as one of our short-term investment options? Our analysis becomes a bit more challenging. While the yield on a given 3- or 6-month security is certain, the future yield of the LGIP is unknown. The LGIP yield for a particular month is based on the earnings received during that month, a direct result of investments and interest rates offered by the market during that month. Unless you can predict the market and interest rates with great precision, you cannot predict exactly what the LGIP yield will be for a given month. Furthermore, the exact yield for a given month is not known until month-end.

However difficult, part of the decision-making process when using the LGIP as a short-term investment option is to *estimate* the yield on the LGIP for the time period in question. While it's impossible to predict that yield exactly, if we consider some known facts and history of the LGIP monthly yield, we can improve the accuracy of our estimate. First let's consider what we know:

- The LGIP yield is closely linked to the targeted fed funds rate. If and when the Fed changes the targeted fed funds rate, the LGIP rate will begin to change as well.
 - o While the targeted fed funds will change immediately upon the Fed's decision, the LGIP yield will lag changes in the funds rate;
 - o OST's management strategy for the LGIP portfolio is to lag that rate change as long as possible when rates are falling and as short as possible when rates are rising.
- The LGIP yield is a *monthly* earnings yield; an average of the earnings achieved over the entire month. Therefore, if the Fed changes the targeted fed funds rate, it is important to consider when during the month that change occurs:
 - o For example, if the rate changes during the last week of the month there will be little impact on the LGIP yield for the current month, but a fairly large impact on the yield for the following month.
- Often the market will price-in a move by the Fed prior to an actual move. The LGIP's reaction to that market pricing is minor when compared to its reaction when the Fed actually moves:
 - o When the market prices-in a Fed ease, the LGIP becomes an attractive vehicle for short-term investments because of its modest reaction to the market's lower yields;
 - o Alternatively, when the market prices-in a rate hike, the LGIP becomes less attractive because of its delayed reaction to rising rates.
- The further out into the future we try to estimate the LGIP yields, the less precise our estimates will be.

Next let's look at some history. The table on page 5 shows the LGIP net rate and the targeted fed funds rate over the past twelve months:

continued on next page

Investing 101

continued

	LGIP Net Rate	Targeted Fed Funds
Oct '02	1.73	1.75
Nov '02	1.55	1.25
Dec '02	1.45	1.25
Jan '03	1.31	1.25
Feb '03	1.28	1.25
Mar '03	1.29	1.25
Apr '03	1.24	1.25
May '03	1.23	1.25
Jun '03	1.19	1.00
Jul '03	1.09	1.00
Aug '03	1.06	1.00
Sep '03	1.07	1.00

In November 2002, the Fed eased 50 basis points (bp), from 1.75 percent to 1.25 percent. The targeted funds rate remained at 1.25 percent until June 2003, when the Fed eased again to 1 percent. The market had priced-in both Fed moves well in advance of the FOMC decisions. However, as the table illustrates, the LGIP yield reflected little change until the actual eases, in November and June. The ease in November occurred early in the month, on Nov. 6, while the ease in June occurred late in the month, on June 26. Accordingly, the impact of the ease affected the November LGIP yield much more than it did the June yield.

Following the Fed ease in early November 2002, 3-month investments were being offered at slightly more than the targeted funds rate of 1.25 percent. But because of its lag effect, the LGIP was able to maintain an average yield of 1.42 percent, 17 bp better than the targeted fed funds rate, for the first several months after the ease. The LGIP yield gradually approached the lowered targeted fed funds rate and lingered there until the next rate change.

As you can see, when considering the LGIP as a short-term investment option, it is very important to be familiar with both current and past targeted fed funds levels, as well as dates of any rate changes, and to be aware of upcoming Fed meeting dates when rates might change. It is also helpful to know the general consensus of investors regarding future movements by the Fed. For example, the current consensus among investors is for the Fed to hold targeted funds at 1 percent into the foreseeable future. This has been mentioned by the Fed in post-meeting statements and in comments by the individual members in various speeches. Given that information, it would be fair to estimate that the average LGIP yield over the next few months will be approximately 1 percent.

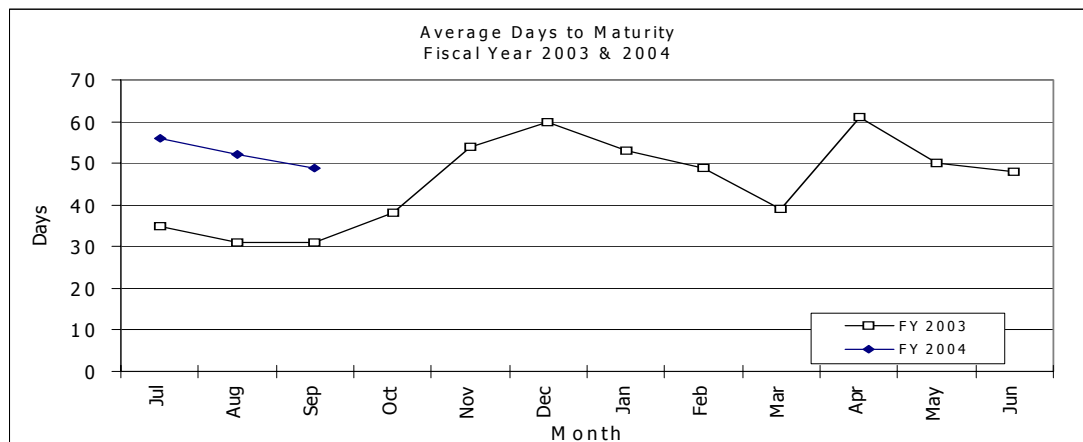
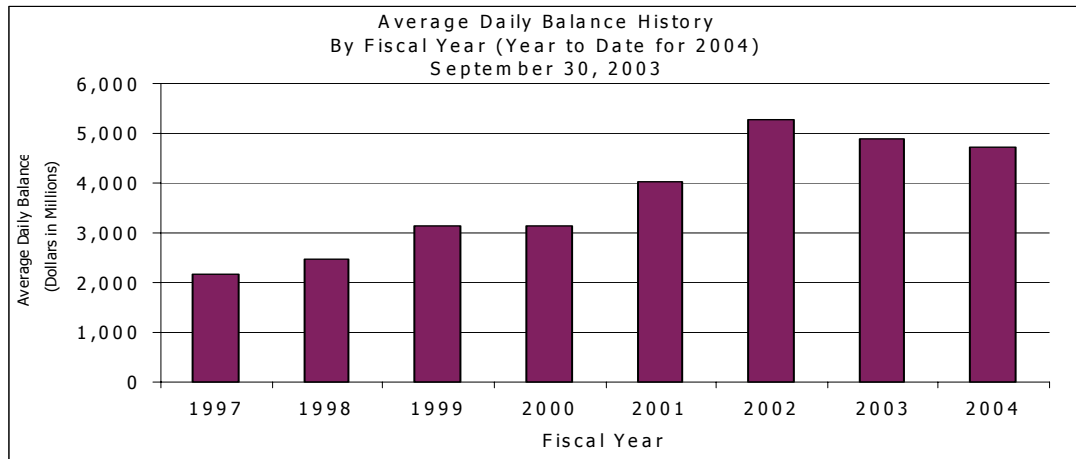
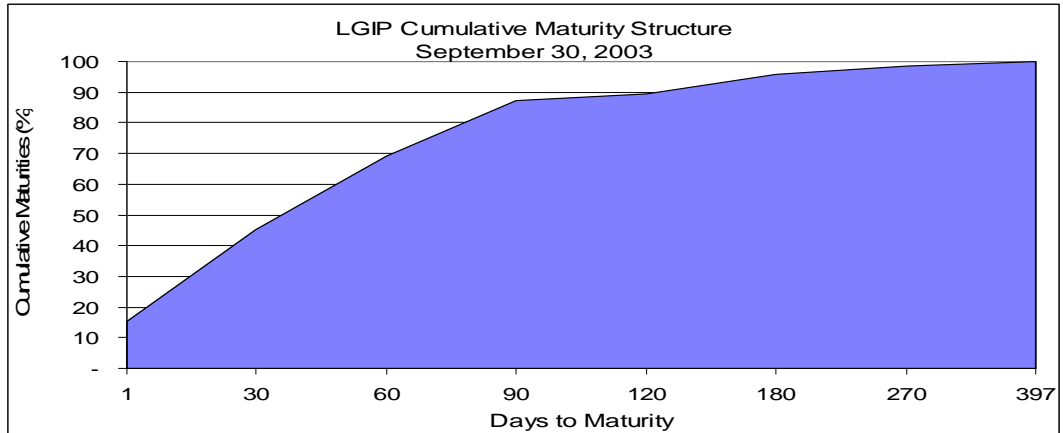
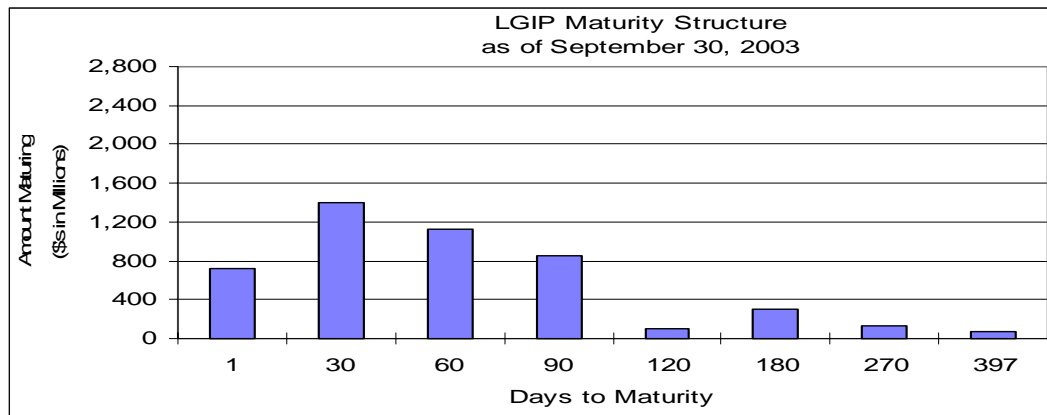
Part 2 - Evaluating the LGIP against other options

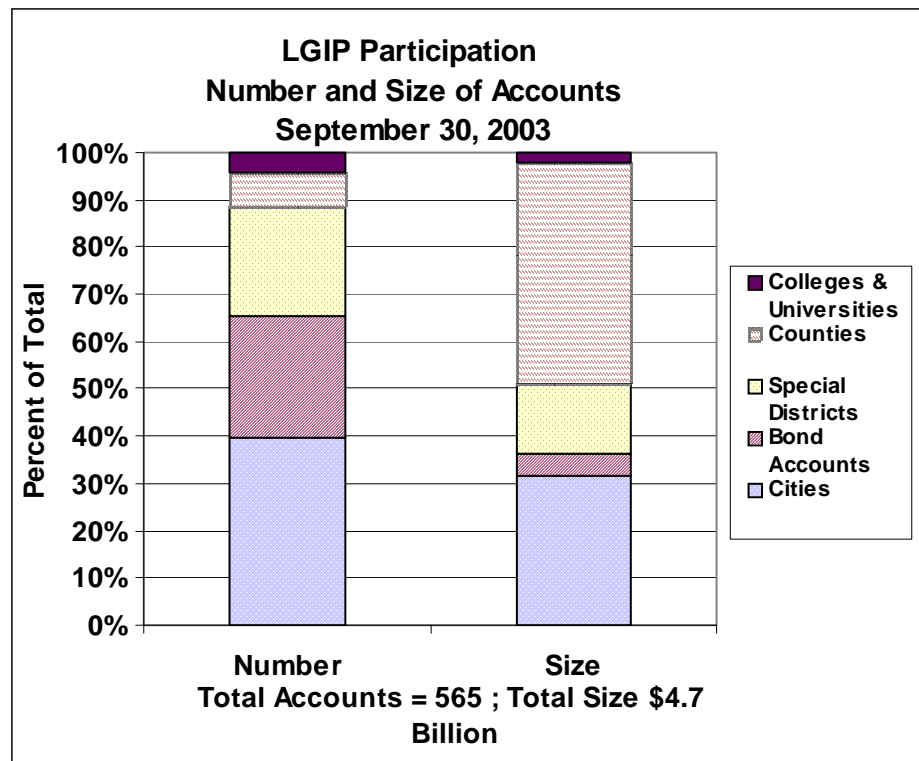
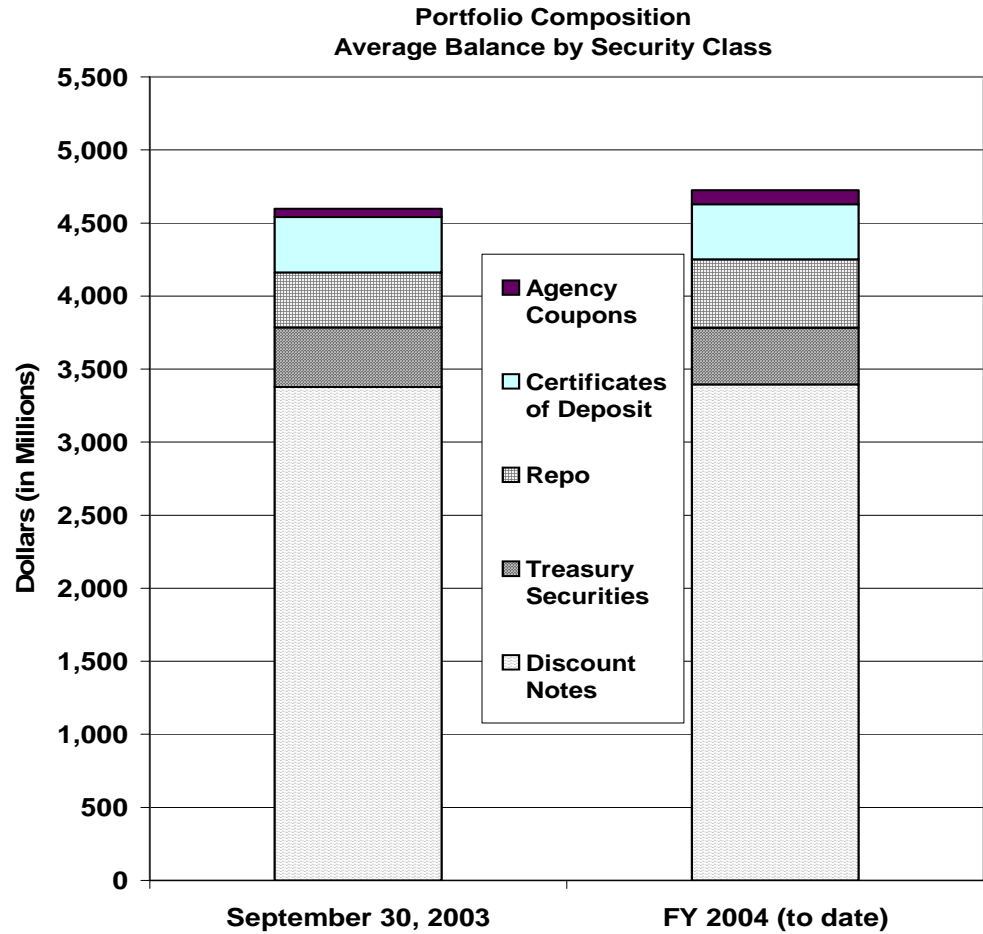
Suppose you currently had money that could safely be invested for three months. You are considering **Option 1**, a 3-month security offered at 1.30 percent, and **Option 2**, the LGIP. If your outlook is that fed funds will stay at 1 percent for the next several months, and you know that the LGIP yield will remain close to the fed funds rate, it doesn't take much analysis to conclude that the 3-month security at 1.30 percent is very attractive. However, what if you were considering similar options in a Fed-tightening environment?

Looking at another example, let's say you are considering a 4-month security offered at 2.65 percent, and the LGIP is showing 2 percent for the current month. Suppose it is near month-end and the Fed has just raised the funds rate by 25 bp to 2.25 percent. The Fed will meet twice more before the 4-month security matures, and there is heavy speculation rates will continue to rise.

At first, the 4-month security, 65 bp over the LGIP, seems like a good investment, but your evaluation should be a bit more in-depth. First, it is fair to assume the LGIP will not *exceed* the funds rate during this time period because of the lag inherent in LGIP yields. One way to evaluate this option is using an "LGIP best case scenario" approach, assuming the LGIP yield will *match* Fed funds. If the Fed raised rates by 25 bp at the next two meetings, the funds rate and the LGIP would be at 2.75 percent; 10 bp greater than the 2.65 percent yield on the 4-month security. Using this approach, the 4-month security may not seem so attractive. However, there are some other factors we must take into account. If we consider the amount of time spent at each

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WFOA 2003 – Another super conference

WFOA 2003, "Bridging the GAAP," was a great success. More than 475 finance professionals from around the state, and a host of out-of-state guests, attended this year's annual conference in Spokane. Conference education tracks ranged from **Accounting/Auditing to Proprietary & Utility Issues**. There was an impressive array of class topics, from "Beefing up Budgets" to "Water Rate Structures" and everything in between. Congratulations to the Local Committee and to everyone involved in making it another outstanding event.

OST was especially proud of the 2003 Public Finance track. All of the sessions, from John Mitchell's "Economic Update" to The Bank of New York's "Fiscal Agent Website," were well attended and well received. Unfortunately, due to complications from Hurricane Isabel, we were forced to cancel the "Freddie Mac" presentation – but we promise to try again next year.

And speaking of next year (What? Already?!) ...

We continue working hard to improve our classes and Public Finance lineup. We want to make them as useful, up-to-date, and timely as possible – but we need your help. If you attended any of the Public Finance sessions and have comments, or have recommendations for future sessions, we want to hear from you. Comments and suggestions may be directed to Lisa Hennessy at (360) 902-9013, or lisa@tre.wa.gov.

We've reviewed our investment policy – Have you?

Each year the LGIP investment policy is reviewed to make sure it continues to meet the needs of our investment program and remains consistent with guidelines and procedures. Although this year's review did not result in any major modifications, we did incorporate a few minor technical revisions to clarify language in the Investment Restrictions section.

The policy now specifies that at *all restrictions are based on a settlement date basis*. Also, investment restrictions now refer to floating rate *instruments* rather than "notes." And finally, language was added to clarify pricing for repurchase agreements.

The modifications were approved by the LGIP Advisory Committee and signed into effect by Treasurer Murphy on October 10. The LGIP Investment Policy is available online at www.tre.wa.gov, or contact Lisa Hennessy at (360) 902-9013 for hard copies.

LGIP Holiday Schedule for 2003 and 2004

The Local Government Investment Pool will be closed on the following days:

2003

Thurs/Fri	November 27-28	Thanksgiving holiday
Thursday	December 25	Christmas Day

2004

Thursday	January 1	New Year's Day
Monday	January 19	Martin Luther King's Birthday
Monday	February 16	Washington's Birthday
Monday	May 31	Memorial Day
Monday	July 5	Independence Day
Monday	September 6	Labor Day
Monday	October 11	Columbus Day
Thursday	November 11	Veteran's Day
Thurs/Fri	November 25-26	Thanksgiving holiday
Friday	December 24	Christmas
Friday	December 31	New Year's

Washington State Local Government Investment Pool
Position and Compliance Report
as of 09/30/2003
(Settlement Date Basis)

LGIP Portfolio Holdings

	Cost	Percentage of Portfolio
Agency Bullets	\$ 59,903,513	1.27
Certificate of Deposit	105,150,000	2.24
Discount Notes	3,313,999,429	70.49
Interest Bearing Bank Deposits	273,095,887	5.81
Repurchase Agreements	601,872,000	12.80
U.S. Treasuries	247,560,690	5.27
U.S. Treasury Bills	99,712,465	2.12
*Total Excluding Securities Lending	4,701,293,984	100.00

Securities Lending Holdings

Repurchase Agreements	219,593,649
Total Securities Lending	219,593,649

Total Investments &

Certificates of Deposit	\$ 4,920,887,633
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Policy Limitations

*The policy limitations include investment of cash collateral by a securities lending agent calculated as percentages of the portfolio holdings Total Excluding Securities Lending.**

Size Limitations

	Portfolio Holdings	Percentage	Policy Percentage
Certificate of Deposit	105,150,000	2.24	10%
Leverage - Sec Lend + Rev Repo	214,755,101	4.57	30%

Maturity Limitations (Days)

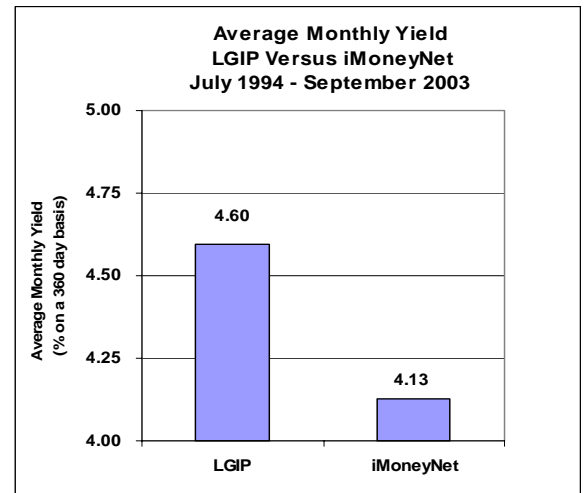
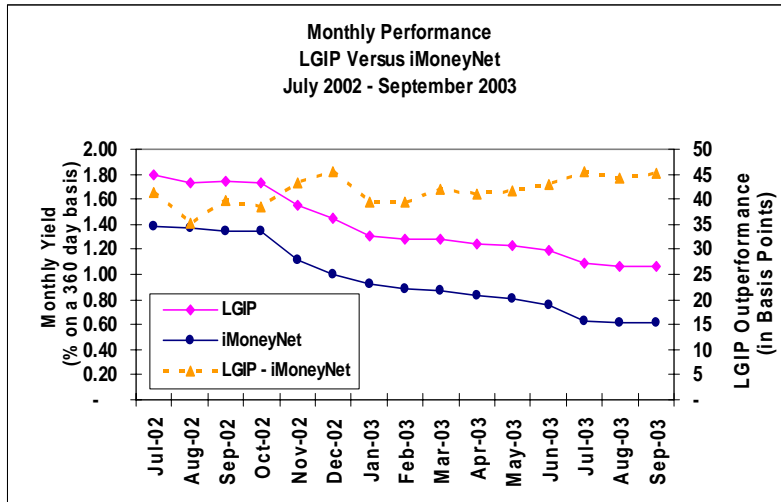
	Currently	Policy
Average Life	49	90
Maximum Maturity	305	397
Maximum Maturity of Repos	2	180
Maximum Maturity of Reverse Repos	0	90

Repo Limits Per Dealer

	September 30, 2003	Total Repo Percentage (20% limit)	Term Repo Percentage (10% limit)	Projected Redemptions 10/1/2003	Projected Position 10/1/2003
Banc America Securities	\$ 250,000,000	5.32%	0.00%	250,000,000	-
Goldman Sachs	219,593,649	4.67%	0.00%	219,593,649	-
Lehman Brothers Inc.	201,872,000	4.29%	0.00%	201,872,000	-
Morgan Stanley Dean Witt	150,000,000	3.19%	3.19%	-	150,000,000
Total	\$ 821,465,649			671,465,649	150,000,000

LGIP Performance Comparison

iMoneyNet, Inc.¹ versus Local Government Investment Pool



The chart on the left shows a monthly comparison from July 2002 through September 2003 and how the LGIP has consistently outperformed the benchmark.

The chart on the right shows an average monthly yield comparison from July 1994 to September 2003. The LGIP net rate of return has outperformed its benchmark during that time period by an average of 47.1 basis points. This translates into the LGIP earning \$139.51 million over what the average comparable private money fund would have generated.

¹ Average Net Rate of Return of Government Only/Institutional Only Money Market Funds, Money Market Insight, iMoneyNet, Inc., Westborough, MA. This benchmark is comprised of privately managed money market funds similar in composition and investment guidelines to the LGIP.

Local Government Investment Pool

STATEMENT OF NET ASSETS

September 30, 2003

Assets

Investments, at Amortized Cost:

Repurchase Agreements	601,872,000
U.S. Agency Coupons	59,903,513
U.S. Agency Discount Notes	3,313,999,429
U.S. Treasury Securities	347,273,155

Total Excluding Securities Lending

& Securities Purchased But Not Settled

4,323,048,097

Securities Lending Investments, at amortized cost:

Repurchase Agreements	219,593,649
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Total Investments (Settlement Date Basis)

4,542,641,746

Due from Brokers - Securities Purchased But Not Settled,
at Amortized Cost:

U.S. Agency Discount Notes	99,839,778
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Total Investments (Trade Date Basis)

4,642,481,524

Interest Bearing Bank Deposits

273,095,887

Certificates of Deposit

105,150,000

Cash

18,029

Interest Receivable

4,070,854

Total Other Assets

382,334,770

Total Assets

5,024,816,294

Liabilities

Accrued Expenses

266,642

Obligations under Securities Lending Agreement

219,593,649

Investment Trades Pending Payable

99,839,778

Total Liabilities

319,700,069

Net Assets

\$ 4,705,116,225

Participant Net Asset Value, Price per Unit

\$ 1.00

Total Amortized Cost - Settlement Date Basis

\$ 4,920,887,633

QUARTER AT A GLANCE

July 1, 2003 to September 30, 2003

Total investment purchases:	\$	20,552,648,027
Total investment sales:	\$	881,924,368
Total investment maturities:	\$	20,250,992,161
Total net income:	\$	13,241,967
Net of realized gains and losses:	\$	202,709
Net Portfolio yield (360-day basis):		

July 1.0866%

August 1.0620%

September 1.0651%

Average weighted days to maturity:

49 days

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